TERM EASEMENT WHITE PAPER

Drafted by the Colorado Coalition of Land Trusts

February 2001

Term easements (conservation easements of less than perpetual duration) have garnered a lot of attention in Colorado recently, and the subject shows no signs of disappearing from the political and conservation landscape in the near future. For example, in July 1999 the State Board of the Great Outdoors Colorado Trust Fund (GOCO) directed the GOCO staff to research a pilot project for term easements. In 1996, GOCO approved $100,000 to the Yampa Valley Legacy Conservation Lease program to create a pilot term easement program. In 2000, the Colorado General Assembly considered legislation (H.B. 1353) to grant a state income tax credit to donors of term easements in addition to donors of perpetual conservation easements. The Governor’s 2000 Commission on Saving Open Spaces, Farms and Ranches advocated, although without consensus among its members, the creation of term easements as part of its recommendations to the Governor. GOCO is currently conducting a study examining the demand for term easements in Colorado through Colorado State University.

The purpose of this white paper is to offer unbiased assessments of term easements and to examine their potential benefits and disadvantages. This paper is not a position paper, but merely an assembly of the results of CCLT’s research into the concept of term easements. Such research was conducted through members of the national land trust community, attorneys familiar with conservation easements, GOCO, proponents of the use of term easements within the agricultural community and others. CCLT believes that by assembling this information in one paper, CCLT’s members will have the background information on term easements with which to determine their own position on the use of these instruments. In addition, this information should assist CCLT and its members in communicating their position to the members of the General Assembly, the Governor and their community.

Definition of a Term Easement

A term easement is a conservation easement for a limited number of years. It is a legal document negotiated by the landowner and the government or land trust that will hold the term easement. In a term easement document, the landowner agrees to not perform specifically enumerated activities (e.g. development). The term easement may require the landowner to specifically perform enumerated activities (e.g. the improvement of wildlife habitat). A term easement is an interest in real property under Colorado law and must be recorded in the real property records of the clerk and recorder’s office. Colorado statutes provide that a conservation easement may be of less than perpetual nature if so stated in the easement (C.R.S. §§38-30.5-103). Generally, in Colorado, term easements are proposed to temporarily conserve lands classified as agricultural lands for property tax purposes, although some have argued for extending term easements to any type of land in the State.
Questions about Valuation of Term Easements and Landowner Compensation

1. How is the value of a term easement to be calculated?

“Fair Market Value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts.” (Treasury Regulation Section 1.170A-1(e)).

There are many types of appraisal techniques, including survey-based techniques known generally as contingent valuation methodology (CVM) and the more traditional (and generally accepted) valuation methodologies associated with real estate appraisal (Cost, Income Capitalization and Sales Comparison). One CVM technique is based on survey methodology, where a random sampling of the population may be asked, “What would you pay to be certain that the view from the Dallas Divide remains as it is today?” The results of the survey can then be extrapolated to demonstrate the ‘value’ of that particular view to the American people or any other subgroup.

The traditional market value appraisal techniques accepted by the federal government and most other jurisdictions, as well as the lending community, are based on principles of supply and demand, competition, and substitution. They attempt to reflect market behavior as it relates to a specific type of property in a specific location. Some Colorado ranches must be valued in the context of the western U.S., and some in the context of the world’s priciest resort markets. In the final analysis, the appraiser’s opinion of value must be based on the property’s ability to generate income, either by exploitation of its resources or by comparing it with the sale of comparable properties.

2. What is the value of a term easement?

For years, land leases for agricultural, residential, and commercial development uses have been entered into. In many non-agricultural markets, annual lease payments of between 8% and 12% of the full fee simple value of the land are customary. These so-called land leases typically have terms of from 5 years (usually with renewal options) to 99 years. Leases cannot be perpetual. While it is logical and appropriate to apply this same approach to a hypothetical lease of “development rights” on agricultural land, it is crucial to base the easement rent on what is being acquired. So, if the development value of a property is a small component of its total market value, and the objective is to “rent” that development right from the agricultural producer for a fixed period of time, then the rental amount must be based on the value of what is being rented, not on the value of the entire farm or ranch. We must be prepared for the fact that some properties in Colorado, believe it or not, have very little development value.

Leasing of agricultural land, though, often does not follow the same pattern of leasing commercial or residential land. It is customary for owners of agricultural land to
structure rental payments based on the land's productivity, often in consideration of crop yields (for cropland or hay ground) or potential weight gain of livestock (for pasture). It is not unusual for agricultural leases to be used as a management technique where the owner does not wish to sell outright but needs to have the land looked after and generate enough income to retain the agricultural classification for property tax purposes and pay the property taxes.

The valuation of term easements using accepted appraisal techniques will necessarily consider all factors affecting property value. It will always boil down to the highest and best use of a property before and after conveyance of an easement. If the property has high development value, the market value of an easement intended to prohibit development will be a very significant percentage of total property value. If the property has low development value, the market value of that same easement will be very small.

The market value of a term easement is going to be some percentage of the value of a permanent easement with the same restrictions. The greater the length of a term easement, the greater the percentage its value is of the value of a permanent easement. If the permanent easement has a high value, then a fairly long-term easement (for example, 25-years) is going to be valued at a large percentage of the value of the permanent easement. If the permanent easement has a low value, the term easement is going to have a low value whether it is for a long or short period.

3. What is fair and publicly supportable compensation to the landowner for a less-than perpetual restriction?

This is the question that has thwarted several term easement proposals. If annual payments are calculated based on the difference between the lease value of developable land and the lease value of agricultural land (or formulas based on a similar notion) then the sum of those payments over 20 or 30 years might approach, or exceed, the cost of outright purchase. On the other hand, if an arbitrarily low one-time payment is used (like the Pennsylvania possibility of purchasing a 25-year conservation easement for 10% of the appraised price of a permanent one) then farmers won't find it worthwhile to participate.

One way out of this conundrum is to completely decouple estimates of the land value that is temporarily being given up from the amount of the payments going to the landowner. By instead providing benefits in the form of economic development consulting assistance, or additional tax benefits, or access to low-cost capital, the value is in the form of actual benefits received, not compensation for foregone land use options.

4. How does a potential term easement holder determine if an investment in a term easement is fiscally prudent?

The key criteria to assessing whether or not funds invested in a term easement are cost-effective are: (a) the length of the term, (b) the cost of the term easement, (c) the
restrictions granted by the term easement, and (d) whether or not the easement contains a right of first refusal or an option to buy.

Questions about Estate, Gift, and Other Taxes

1. What are the gift tax implications for the donation of a term easement?

In his Second Supplement (1988-95) The Federal Tax Law of Conservation Easements, Steve Small wrote “A land trust that is approached by a landowner with an offer of a nonperpetual conservation easement should be sure to notify the landowner that such a donation not only does not qualify as a tax-deductible gift but could also incur a gift tax.” (Page 28)

Section 2522(d) of the tax code exempts perpetual conservation easements from the federal gift tax. Because the code doesn’t include term easements in the exemption, the presumption is they are not exempt from the gift tax. Therefore, the donation of a term easement is by definition a taxable gift.

There is a school of thought that a conservation easement represents a liability in the hands of the donee and, therefore, its value for gift tax purposes should be zero. If this is true, it does not make any practical difference if the donation of a term easement is subject to a gift tax. However, there is no precedent for the position that a donation of a term easement should be valued at zero, so the risk of a gift tax remains.

If a landowner were willing to accept less than the established price for a term easement, would there be any tax deduction available? The answer is “probably not.” Many purchases of permanent easements are at bargain sale prices, meaning that local tax dollars are supplemented by compensation to the landowner by way of the federal tax code. The IRS partial interest rules may work to prevent any federal tax benefits from applying in the “bargain sale” of a less-than-permanent conservation restriction.

2. What are the issues for a decedent’s estate when the estate includes property encumbered by a term easement?

Similar to the gift tax, there is an estate tax deduction in Internal Revenue Code § 2055(f) for a perpetual conservation easement. There is no deduction for a term easement. Therefore, the donation of a term easement will not remove any value from a decedent’s estate. The full value of the land will be taxed at the time of death of the landowner without regard to the term easement.

There is a fundamental problem with creating tax benefits at the state level which do not match the federal tax system. This is considered by some to be poor tax policy.

If the landowner dies during the term of a term easement, the heirs will have to pay estate taxes on land not reduced in value for estate tax purposes, but land which is restricted in value in the marketplace.
3. What are the other tax issues?

Are there any tax problems if the landowner receives one payment for the full value of the term easement? Answer: A one-time payment for a term easement might be a capital gain.

Are there any tax consequences to a landowner who receives annual payments for the full value of the term easement over the life of the easement? Answer: The leasing of term easements could also be tricky from a tax standpoint as it is unclear whether or not the income should be treated as ordinary income or a capital gain.

Potential Options to Strengthen the Concept of Term Easements

The following are some suggestions that a landowner and a holder of a term easement could negotiate for inclusion in the easement:

1. Option to Purchase. Some term easement proposals provide the holder of the easement with an option to buy a permanent conservation easement, at a predetermined price, at the time the term easement expires. An option to purchase runs with the land and the purchase price must be listed at the time the term easement is negotiated.

2. Right of First Refusal. A term easement can be drafted to include a right of first refusal (to buy the land in fee) on behalf of the holder of the easement at such time as the landowner decides to sell the property (most likely after the term easement expires). A right of first refusal runs with the land and gives the holder of the term easement the right to match the purchase price if the owner ever decides to sell the property. It might be very expensive to exercise such a right, but at least there would be an opportunity to protect the public investment made through the term easement at some point in time. One difficulty with the right of first refusal is that the purchase price and the purchase date will not be known until the landowner decides to sell and an offer is made on the property.

3. Other Proposals. Another proposal would require the landowner to return all or partial payments made to date (plus interest) if he or she elects to sell for uses other than as permitted under the provisions of the term easement. However, it may be difficult and costly to force the landowner to repay any or all funds due.

Reality Check

1. Term easements are already permitted under Colorado law, section 38-30.5-103.
2. Some of the arguments for/against term easements are based on estimates of future conditions. For example:
   - Public funds available for open space preservation will/will not increase at the same rate as the price of land.
3. Some of the arguments for/against term easements are based on estimates of human behavior. For example:
   • If the value of the term easement is too low, a landowner may be unwilling to tie up his or her property with a term easement.

4. Some arguments for/against term easements concern the criteria that might/might not be adopted by an agency or the legislature to determine which term easements should receive monies. Examples are:
   • Developers will land bank land for development.
     (Legislation or criteria by the funding agency could close this loophole.)
   • Land under a term easement would very likely be developed at the expiration of the term.
     (Legislation or criteria by the funding agency could require an option to buy or a right of first refusal.)
   • Term easements intended to protect agricultural land can be sought by any landowner with agricultural land (hobby ranchers, developers).
     (Legislation or criteria by the funding agency could require a needs or means test where it must be proven that a certain amount of a landowner’s income is derived from the production of food or fiber.)

*Arguments for Term Easements:*

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<tr>
<td>A</td>
<td>Since a term easement is likely to be valued at a lesser amount than an easement in perpetuity, scarce public dollars used for term easements will afford more open space protection than if they were used for an easement in perpetuity.</td>
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<td>B</td>
<td>A term easement program is similar to the Conservation Reserve Program where agricultural producers are paid not to produce anything on their property for a period of ten years. In most cases, when the term has expired, the landowner has renewed. The landowner is paid approximately 70% of the value of what could have been produced on the property.</td>
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<td>C</td>
<td>If preserving qualified land in perpetuity provides public benefit, one would assume preserving the same land for twelve years or more also provides public benefit. Term easements provide an incentive for landowners to provide a public benefit.</td>
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<td>D</td>
<td>Term easements offer another “tool” for preserving land and another preservation option for landowners.</td>
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<td>Term easements do not “tie the hands” of future landowners.</td>
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<td>F</td>
<td>What an agricultural producer often looks for is another way to supplement their income thus making their ranching operation profitable. Term easements with an annual payment would help ranchers stay in operation and compensate them for the open space they provide.</td>
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<td>G</td>
<td>No one knows if there is a future in this State for agriculture, so putting agricultural land in a term easement preserves open space on a short-term basis but doesn’t force a landowner to stay in an unprofitable business in the future.</td>
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<td>Term easements may provide an opportunity to work with landowners not currently interested in permanent easements. Two potential benefits of this come to mind: 1) a landowner may warm to a permanent easement over time, and 2) land would be preserved (albeit, not permanently), that would not otherwise be preserved.</td>
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**Arguments against Term Easements**

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<tr>
<td>A</td>
<td>If the value of the term easement is too close to the purchase price of an easement in perpetuity, it makes sense to use scarce public dollars to purchase an easement in perpetuity rather than a term easement.</td>
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<td>B</td>
<td>Since GOCO and other open space funds are limited, and as there are many good, unfunded projects that preserve land permanently as open space, it is not good fiscal policy to fund projects that only temporarily restrict development rather than those that will protect open space permanently.</td>
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<td>C</td>
<td>There is no dearth of agricultural landowners who either have or would like to preserve their property with a conservation easement in perpetuity so there is no need to offer term easements to these same landowners.</td>
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<td>D</td>
<td>Term easements for agricultural lands are identical to a subsidy paid to a single industry. Subsidies have no place in a free market system.</td>
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<td>E</td>
<td>Funding term easement programs may eliminate the opportunity to fund permanent protection programs.</td>
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<td>F</td>
<td>Proposals that do not permanently protect productive agricultural land will not accomplish the goal of preserving America’s farmlands. If land is not permanently preserved for agricultural production, America will become dependent upon other countries for its food supply much as it is currently dependent upon other countries for oil. Such a situation could lead to embargoes, price increases and other adverse consequences to food availability.</td>
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<tr>
<td>G</td>
<td>Term easements will be subject to abuse as a profitable form of land banking for future non-agricultural uses.</td>
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<tr>
<td>H</td>
<td>Term easements will have a negative impact on the voluntary land conservation movement. The public will not understand and be able to differentiate between perpetual and term easements.</td>
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<td>I</td>
<td>It will be difficult if not impossible, to look for funding to preserve the land as open space if the original term easement does not contain a right of first refusal or an option to either acquire the land or place a permanent easement on the land.</td>
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<td>J</td>
<td>Land values in Colorado are likely to continue to increase at a greater rate than the increase in either the rate of inflation or the growth in the economy. If this is the case, then it will cost even more to purchase the land in the future than it does today in absolute dollars.</td>
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<td>K</td>
<td>A term easement program is similar to the federal government’s Conservation Reserve Program (CRP) and the Wetlands Reserve Program (WRF). [CRP leases are for 10 years, and WRP leases are for 30 years.] CRP costs the federal government $1.8 billion per year. The program is very expensive.</td>
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<td>L</td>
<td>Landowners who have enrolled in the Conservation Reserve Program for 2-3 times have received more money from payments for keeping their land out of production (based on what they could have received on the open market for the value of their crops) than they would have received if they had sold their property to the government for its fair market value. Renewing term easements will eventually result in the public paying more for a term easement than it would have cost to buy a perpetual easement or even the fee interest in the land.</td>
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It is possible that violations that occur late in the life of a term easement might go unenforced due to the cost of enforcement and/or remediation. The holder of the easement would have to balance the cost of enforcement against the fact that the term easement was about to expire. The landowner could consciously or unconsciously violate the easement gambling that the holder of the easement would not spend time and effort enforcing an easement that is about to expire anyway.

As land trusts are small non-profit organizations operating on lean budgets, and as all land trusts have many projects to work on, they likely cannot afford to devote any of their scarce funds or staff time to projects that do not permanently protect open space.

*CCLT did not evaluate the merits of these arguments, but simply reports them as collected from individuals and organizations interested in the term easement discussion.*